ATTORNEYS AT LAW

SW&M

STYSKAL, WIESE & MELCHIONE, LLP 550 NORTH BRAND BOULEVARD SUITE 550, GLENDALE, CA 91203-1988
TEL: 818.241.0103 FAX: 818.241.5733 EMAIL: swm@law4cus.com

L.J. STYSKAL / DECEASED, 1974 A.O. WIESE JR. / RETIRED FROM THE FIRM, 1987 E.J. MELCHIONE / DECEASED, 1986

VIA EMAIL AT: regcomments@ncua.gov
ORIGINAL MAILED SAME DAY

March 31, 2008

Mary Rupp, Secretary of the Board
NATIONAL CREDIT UNION ADMINISTRATION
1775 Duke Street
Alexandria, Virginia 22314-3428

Re: Comments on Advanced Notice of Proposed Rulemaking for Parts 708a and 708b

Dear Ms. Rupp:

This letter is written on behalf of Styskal, Wiese & Melchione, L.L.P., a law firm located in Southern California which represents numerous credit unions, both state and federal. The firm began representing credit unions in all aspects of their operations on an almost exclusive basis in 1987. We offer the following discussion as a comment on the Advance Notice of Proposed Rulemaking for Parts 708a and 708b of the NCUA's Rules and Regulations, issued January 30, 2008 ("ANPR").

We believe an accurate summary of the subject matter of the ANPR to be board responsibilities and member rights in certain types of fundamental corporate change. Fundamental corporate change is generally defined as an alteration in a corporation that requires a charter amendment and thus the consent of the equity shareholders as parties to the contract represented by the charter. This category includes merger, consolidation, sale of substantially all of a corporation's assets, amendment to articles of incorporation, and dissolution, and for federal credit unions would also include charter conversion and change in account insurance. The reason this category of corporate actions is and should be provided with special protection is that equity ownership claims on an entity are "residual in priority[1] and poorly defined" and thus do not lend themselves well to enforcement by contract law or any other legal protection.[2] This residual

[1] Equity owners in a stock institution only receive their interests in the corporation upon sale to a third party, redemption by the corporation, or liquidation of the corporation. Shares in a cooperative do not reflect ownership in their value, and thus equity ownership in a cooperative like a credit union can only be realized at liquidation.
[2] Theodor Baums & Kenneth E. Scott, *Taking Shareholder Protection Seriously? Corporate Governance in the United States and Germany*, 53 Am. J. Comp. L. 31, 34 (2005).

ownership is one of the primary aspects of corporate shareholders and credit union members alike.[3]

Regarding these fundamental corporate change situations, the NCUA has specifically asked about communications to members, voting integrity, fiduciary duties of directors, and member interest in equity. The statement of issues in the ANPR, "accuracy of communications to members, voting integrity, fiduciary duty obligations for insiders, and member interest in credit union equity,"[4] captures what we believe to truly be the issues of fiduciary duties of credit union directors and management, oversight of director performance, and remedies for breaches. While we believe that the specifics of member voting, tallies, and recounts can be vital to the outcome and fairness of the democratic process, we believe that the most important issue of those raised in the ANPR is the fiduciary duties of directors.

We believe various aspects of the law already subject federal credit union directors to significant obligations. Under many statutes and states' laws, these are heightened in the context of fundamental corporate change and particularly in transactions in which the directors may reap some benefit or the members may lose their equity interests. However, because of the myriad of different laws and various standards, this area presents a confusing picture for federal credit unions. We believe a common worry among the NCUA's constituents is that in the absence of definite rules, federal credit unions will be required to muddle through this area, or that the ultimate decisions will be left to courts.[5] To solidify this area of the law, the NCUA needs to engage in comprehensive rulemaking dictating standards of care and loyalty, ways of dealing with conflicts of interest, standards for forthrightness of communications with members, and remedies for members who dissent from their credit union's decisions regarding fundamental corporate change.[6]

As noted by corporate law scholars since the early twentieth century, the danger of fundamental corporate change is that it will remove the value invested in the corporation or the ownership interest in the corporation of all or some of the equity owners of the corporation. This worry is no different for the fundamental corporate changes discussed in the ANPR. Fiduciary duties,

---

[3] As the NCUA stated in its most recent final rule on conversions, "Ownership is measured not only in terms of possible rewards, but also in terms of the assumption of risk." 71 Fed. Reg. 77150, 77153 (2006).
[4] 73 Fed. Reg. 5461, 5462 (2008).
[5] We note that courts acting without guidance from the NCUA have in the past reached conclusions we feel in line with the NCUA's general position as expressed in previous regulations, but have also reached conclusions that have seemed anomalous and out of step with the idea of credit union members as equity owners. As is discussed in later sections of this letter, the uncertainty in the law at this time could result in a court deciding in such a way as to deprive members of their rights as equity owners and to relieve directors of their fiduciary responsibilities to their members. From the decisions in a number of court cases, we have grown confident that courts will not protect member interests without exceedingly clear laws and regulations.
[6] At the same time, we acknowledge that many credit unions are concerned about additional regulation and its possible burdens. For this reason, we suggest comprehensive and understandable rules. Such rules would eliminate, rather than create, confusion for the directors and officers of federal credit unions.

recusal standards, regulation of communications, and private remedies have generally been the answer to these worries. Additionally, in other countries and recently as relates to publicly traded corporations, an oversight board of sorts has been implemented or suggested. Each of these components to a comprehensive solution to the fundamental corporate change problem is discussed in detail below.

I. Standards of Care and Loyalty

The NCUA has stated, and NCUA Rules and Regulations state, that in certain situations the NCUA may take action against directors for either breaching a fiduciary duty or acting against the interests of credit union members.[7] We understand and agree that this creates a significant obligation for federal credit union directors to act in the interests of the members as well as the interests of their institution.

Even if the existence of these duties is clear, however, the law and regulations as currently written do not provide guidance on the standards by which a federal credit union director should be judged to have fulfilled such duty. For state-chartered entities, many states have enacted statutes which clearly state that directors owe certain duties, often that directors must act "in good faith, in a manner such director believes to be in the best interests of the corporation and with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances."[8] Other states have extensive common law traditions that set out fiduciary duties.[9]

Similar language is not found in federal statutes in relation to any federally-chartered financial institution, but is contained in the regulations governing federal home loan banks.[10] If Congress

[7] *E.g.*, 12 U.S.C. § 1786(g)(1)(A)(iii);12 C.F.R. § 701.14(e); 71 Fed. Reg. 77150, 77156 (2006).
[8] *E.g.*, Cal. Corp. Code § 7231(a).
[9] *E.g.*, Delaware.
[10] 12 C.F.R. § 917.2(b). This section reads:

(b) Duties of Bank directors. Each Bank director shall have the duty to:

(1) Carry out his or her duties as director in good faith, in a manner such director believes to be in the best interests of the Bank, and with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances;
(2) Administer the affairs of the Bank fairly and impartially and without discrimination in favor of or against any member;
(3) At the time of appointment or election, or within a reasonable time thereafter, have a working familiarity with basic finance and accounting practices, including the ability to read and understand the Bank's balance sheet and income statement and to ask substantive questions of management and the internal and external auditors; and
(4) Direct the operations of the Bank in conformity with the requirements set forth in the Act and this chapter.

In proposing such regulations, the FHFB knew that it was enacting state-of-the-art regulations. 65 Fed. Reg. 81, 81 (2000). We also refer the NCUA to the FHFB's discussion of its proposed rule (65 Fed. Reg. 81) and its final rule (65 Fed. Reg. 25267 (2000)).

or the NCUA decided to enact such laws or regulations, we believe they would be enforceable by state and federal courts as federal law, as they have been under the FHFB regulations. However, in the absence of federal statutes or regulations, fiduciary duties for federal credit union directors would have to be determined by either state law or federal common law. Federal courts, for some time, have not been permitted to make federal common law except in cases where there is a "significant conflict between some federal policy or interest and the use of state law."[11] Under a statutory and regulatory scheme similar to that currently in place for federal credit unions (that covering federal savings banks), the United States Supreme Court has ruled that fiduciary duties are determined by state law, not through the creation of federal common law.[12] Thus, the law of fiduciary duties for federally chartered corporations, when left unclear by federal law and regulations will be determined on the basis of state law. In the past, this lack of clear statement regarding the existence of a federal fiduciary duty has resulted in the continued application by courts of fiduciary duty standards from state law.[13]

Some states do not provide for fiduciary duties to equity owners, rather providing only for fiduciary duties to the entities themselves. Some states have enacted differing statutes for corporations, non-profit mutual benefit corporations or other cooperatives, and state-chartered financial institutions.[14] Distinctions in state law have caused problems for member suits in states in the past, as occurred in *Save Columbia v. Columbia Community Credit Union.*[15] How is a credit union or a court to determine which standard, even if they differ only slightly, applies? How is the NCUA to enforce or continue to insist on the existence of a fiduciary duty to the credit union and the members if state law applies to supply the content of the fiduciary duty for federal credit unions?

We agree that federal credit union directors owe a duty to the credit union's members, however, our concern is primarily that a court could still find that state law applies to the standards in the fiduciary duty context and to the question of to whom the duty is owed. It is true that this question remains largely untested in courts, but we believe that regulatory action before litigation would forestall a lengthy and costly debate on this relatively arcane legal issue.

---

[11] Atherton v. FDIC, 519 U.S. 213, 218 (1997).
[12] *See generally id. passim.*
[13] *E.g.*, Gully v. NCUA Bd., 341 F.3d 155, 165 (2d Cir. 2003) ("The parties agree that New York law applies to Gully's claim of breach of fiduciary duty and that the WFCU is considered a corporation for purposes of New York fiduciary law.").
[14] *Compare* Cal. Corp. Code § 7231(a), *with* Cal. Corp. Code § 309(a).
[15] Save Columbia Credit Union Committee v. Columbia Community Credit Union, 139 P.3d 386 (Wash. App. 2006). In this case, directors of a state chartered credit union were deemed not to owe duties to the members of the credit union because the statute controlling duties did not include a reference to duties to members; the statute only provided for duties to the credit union, as does the California statute quoted above. *See* Cal. Corp. Code § 7231(a).

Re: Comments on Advanced Notice of Proposed Rulemaking for Parts 708a and 708b

Also, the NCUA, in the ANPR, noted a need for uniformity for federal credit unions, and that current standards varied from requiring only a rational basis for a decision to requiring boards to engage in a full consideration and documented analysis of all the alternatives. We support this drive for uniformity and certainty for federal credit unions.

The fiduciary standards for the directors of a legal entity should be determined through application of the law of the jurisdiction which created that entity. For federal credit unions, that would be federal law. We believe the NCUA has the power to create regulations in this regard because the Federal Credit Union Act ("FCUA") refers to fiduciary duties and the NCUA's power to perform enforcement actions for their breach, but does not define them.

The NCUA, in its regulations, should give federal credit union directors a standard that provides guidance for their day-to-day affairs—that "federal credit union directors owe a fiduciary duty to act in good faith, in a manner the director believes to reasonably be in the best interests of the credit union and its members, and with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances." The NCUA may also wish to go further to incorporate in its fiduciary duty rules the Business Judgment Rule—that courts and/or Administration officials examining fiduciary duty issues shall not investigate into the prudence of a board action if the action was within the authority of the board, there is no evidence of fraud, no evidence of bad faith, and no evidence of self dealing, and the action is not irrational or grossly negligent.

In many fundamental corporate change transactions, the law should and does impose a higher duty. In many change of control transactions, the exceptions to the business judgment rule as stated above will cause the actions of directors to be subjected to heightened scrutiny. Additionally, for certain types of fundamental corporate change transactions the innate risks of conflicts of interest, self-dealing, or harm to equity interests cause the actions of directors to be subjected to heightened scrutiny.

If the NCUA uses concepts and wording that are applied already in one or more states and that are generally known in the corporate world, it is more likely that courts will react to such standards in a predictable fashion. This will be more likely to supply uniformity and guidance without imposing rigid rules and procedures about which credit union officers and directors may be concerned.

These general principles are discussed in the following sections.

A. Good Faith, Loyalty, and Due Care

In the law of fiduciary duties, both at common law and in statutes such as those cited above, directors are generally considered to have three interrelated duties: Good Faith, Loyalty, and Due Care. Traditionally, Good Faith has been subsumed into Loyalty—a

Re: Comments on Advanced Notice of Proposed Rulemaking for Parts 708a and 708b

director cannot be acting loyally when not acting in good faith toward the interests of the members and institution.

1. Loyalty

The duty of loyalty is the duty to act in the best interests of the credit union and its members. This means, generally, avoiding acting under a conflict of interest, avoiding motivations of entrenchment, and acting in good faith to further the interests of the credit union and its members.

Conflicts of interest in the context of a credit union merger or conversion would be any interest a director or officer may end up having that is not an interest they have in common with the other members. In the corporate context, for example, a director or officer is not conflicted by way of an interest held as a shareholder of the corporation or an interest that is the same as that available to all shareholders alike. Thus, voting on an equity distribution in the event of a merger would not be a conflict of interest, whereas voting on a significant pay raise or other similar incentive might be a conflict of interest.

Entrenchment or perpetuation in office often includes negotiation and voting on the merger based on who will get to participate on the board of the continuing credit union. This is a common example of a director pushing the limits of the duty of loyalty.

Failure to act in good faith is usually only found when a director acts in such a way that it would have an adverse impact on the credit union, such as selling assets for less than market value. While a director might not reap a personal benefit from an act in bad faith, the act still may not be in the interests of the credit union.

In situations where there is or will no longer be an entity to consider, directors then have only the interests of members with which to be concerned. Thus, in situations where the breakup of a credit union or the merger or sale of a credit union is inevitable, the directors must keep in mind an additional point: the interest of the members in recouping their equity interest at the highest value possible. This standard is discussed in further detail in the section titled "Heightened Scrutiny for Certain Types of Transactions" below.

2. Due Care

The standard of care for directors is generally that they act as an ordinarily prudent person in a like position would use under similar circumstances. This standard requires that directors conduct investigations, review reports, ask questions, and

engage in deliberations. In engaging in due diligence, directors are normally permitted to elicit advice from internal experts, employees, officers, and outside experts such as attorneys and accountants.

We believe the NCUA's list of questions to be asked by directors in the context of a conversion provides an excellent roadmap for exercise of the duty of care:

> "What financial services do the majority of my members want? How do I know this? Can the institution best provide these services to its members as a credit union or a bank? If the credit union converts to a bank, how will that affect the rates and fees that the institution charges the members for these services? And if the credit union converts to a bank, will it be able to offer members (now customers) something in the way of services or value that existing banks in the area are not offering?"[16]

We do not believe that the general standard of care is or should be to fully investigate all possible courses of action. This would result in absolute paralysis of board action and with it commerce. However, the standard of care for directors does involve investigation and consideration of different courses of action. Every business decision has alternatives. Therefore, taking a course of action without at least seeking more thorough information on and deliberating on other courses of action, as well as having a legitimate reason for the action taken, would be a breach of fiduciary duty.

In many cases, especially those in which the ownership interests of members is not at stake, such as general business decisions, we believe that the standard is more deferential due to the application of the business judgment rule. However, in certain cases, we also believe this standard may be heightened, as discussed below. Different amounts of investigation, deliberation, and care should be taken depending on the type of transaction and the degree of care appropriate to it according to a reasonable person standard. Naturally, transactions that have a greater impact on the institution, particularly fundamental corporate change, should be treated with a higher degree of care. With a higher degree of care comes more intense investigation, scrutiny, and deliberation on a transaction.

[16] 71 Fed. Reg. 77150, 77155–77156 (2006). We note that these questions, with the addition of questions on valuation of the credit union in the event of a merger, are similar in subject and scope to the questions that have been implicitly suggested in the landmark duty of care cases. *E.g.*, Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985).

Re: Comments on Advanced Notice of Proposed Rulemaking for Parts 708a and 708b

B. The Business Judgment Rule

The business judgment rule is a rule in courts concerning the examination of board action. In order to avoid chilling the risk-taking that is a valid part of business judgment, courts will generally not examine the substance of board decisions. There are limitations on this protective doctrine, however. A court will not offer protection to the board's decision if the action taken was not within the authority of the board, if there is evidence of fraud, evidence of bad faith, or evidence of self dealing, or if the action is irrational or grossly negligent. The business judgment rule, when stated thus, will not apply in many of the situations where the NCUA has concerns regarding the propriety of transactions.

Any fundamental corporate change transaction in which the directors might individually receive significantly greater pay, or any transaction in which the directors appear to be voting on the basis of entrenchment,[17] would show evidence of self-dealing. A merger in which any false statement is made to the members would show evidence of fraud. A lack of due diligence on the part of directors might show that the directors are grossly negligent. Each of these situations, whether in the context of the normal course of business, or a merger, a hostile merger offer, or a conversion, is one with which the NCUA appears to be concerned.

C. Heightened Scrutiny for Certain Types of Transactions

As stated previously in this letter, higher standards and heightened scrutiny apply to certain fundamental corporate change transactions, particularly change in control transactions. In some jurisdictions when there is a tendency for a type of transaction to encourage or promote self-dealing or conflicts of interest, courts will review those transactions with greater skepticism and scrutiny, no matter whether there is any direct evidence of self-dealing. Thus, in jurisdictions following this rule, corporate cash-out mergers are, in general, viewed with greater scrutiny and directors are held to a higher standard; defensive responses to hostile merger offers are treated similarly.

As such, we suggest that for types of transactions that characteristically involve a motive of self-dealing, the NCUA engage in rulemaking that reflects the dangers inherent in them. The types of transactions that might trigger such scrutiny for credit unions are responses to hostile bids, types of mergers in which directors will receive compensation as a result of the merger, or types of transactions in which directors will have opportunities to purchase stock in a manner that is unlike the opportunities for other equity owners—in other words, hostile bids, mergers of credit unions into non-credit unions, and, to the extent it has the power to, conversions.

---

[17] Evidence of entrenchment might be, for example, that a director wishes to be designated as a director emeritus for life, or the creation of any other permanent position, as a deal-point in the merger.

Re: Comments on Advanced Notice of Proposed Rulemaking for Parts 708a and 708b

Various heightened standards could be imposed. The most basic is removing the protection of the business judgment rule and enforcing the negligence standard of the general statement of the fiduciary duty: the care taken by a reasonable person in similar circumstances. This standard corresponds with the "trustee" standards that historically applied to trusts, non-profits, and other similar institutions. Particularly in situations where there is a possibility of members losing their equity interests in an institution, the directors act as gatekeepers and trustees of the members' interests. This should be made clear in the NCUA's regulations.

Other heightened standards are not so different from this one. Under Delaware law, for example, in situations where heightened scrutiny is imposed, more specific tests are imposed. Additionally, in some situations, there are specific dictates for director action. The most clear of these is the example of *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*[18] Under *Revlon*, if a corporation is definitely going to disappear in a hostile merger situation (i.e., even the target corporation fends off one bidder, it is doing so by selling the company piecemeal or entirely to another corporation), the directors no longer have an interest in defending the corporation, and therefore only have a duty to get the highest price available for the shareholders. In the credit union context, if a credit union is certainly going to lose its distinct identity (for example because it is going to merge into a non-sponsor bank or other unrelated financial institution), then the directors would no longer owe a duty to the disappearing entity and would owe a duty only to provide the maximum return of equity and premium on said equity available on the market. Thus, upon the reasoning of *Revlon*, there is and should be a "separate standard of care for transactions where the credit union member will no longer be a member of a credit union."[19] Federal credit union members have a right to the equity in their mutual cooperative and should, if mutual ownership is being terminated, receive the highest price possible.

II. Ways of Dealing with Conflicts of Interest

Not all transactions in which there is a potential for a conflict of interest are categorically against the best interests of the members of the credit union. Additionally, directors should be able to show in some way that they are not interested in a transaction. In all, a type of transaction should not be absolutely precluded because it has a potential for pecuniary interest or conflicts of interest by the credit union's directors. This does not mean, however, such possible conflicts should be ignored.

[18] 506 A.2d 173 (Del. 1986).
[19] 73 Fed. Reg. 5461, 5464 (2008).

Re: Comments on Advanced Notice of Proposed Rulemaking for Parts 708a and 708b

This problem specifically arises in the examples of conversion and merger of a credit union directly into a non-credit union charter institution. As stated in the NCUA's Final Rule on Conversions issued in December of 2006, "if the MSB subsequently converts to a stock bank, as about ninety percent of converting credit unions ultimately do, the vast majority of the former credit union members will likely not subscribe to the stock offering."[20] Similarly, in the event that regulations provide for and the NCUA approves more mergers of credit unions into other charter types, these transactions would also present an opportunity for directors of credit unions to profit significantly at the expense of the members. If a credit union merges into a non-credit union institution, it is unlikely that members will be compensated in stock in the institution for their interests. Rather, they will become depositors, eventually if not immediately, without voting rights. On the other hand, the directors or officers may be offered paid positions in the continuing institution.

We note that credit union directors are already required to certify to the NCUA under Rule 708a that a conversion decision is in the best interests of the members. Further, to protect member interests, we believe that the merger-related compensation proposed rule presents excellent protections for members, and is more lenient than the corresponding rule in place for mutual savings banks.[21]

Additionally, the NCUA could institute rules for the "cleansing" of interested director transactions. These transactions could range from those involving mergers to those involving sale of property to the credit union. Many states have enacted statutes that make transactions that involve one or more interested directors not void if the majority of the uninterested directors or the majority of the uninterested shareholders or directors vote to approve the transaction after the interest is fully disclosed.

We suggest that the NCUA codify some similar standard which includes a requirement that interested directors recuse themselves from a vote if they are to reap a benefit from a transaction, or that they explicitly recuse themselves from a benefit in order to vote on a transaction. We note that some jurisdictions allow otherwise interested transactions to proceed if the interested parties merely disclose the material deal-points to the equity owners. We do not believe that mere disclosure is adequate to protect member interests, especially considering the common law protections in some jurisdictions exempting directors from having to characterize their actions (e.g. anti-self-flagellation rules).

In addition to the regulations we have suggested thus far, we also suggest the NCUA emphasize the role of the supervisory committee in overseeing fundamental corporate change transactions.

---

[20] 71 Fed. Reg. 77150, 77155 (2006).

[21] We admire that the NCUA's proposed rule provides significant flexibility by requiring disclosure, while the corresponding rule for banks, with the same dollar and percentage limitations, makes any greater increase in compensation per se unreasonable. The NCUA may wish to incorporate the proposed rule on Disclosure of Merger Related Compensation Arrangements into a rule developed as a result of this ANPR.

Re: Comments on Advanced Notice of Proposed Rulemaking for Parts 708a and 708b

Supervisory committee oversight is designed to protect the members. The dual-board structure of credit unions is meant to provide additional protections to members.[22] Thus, where the interests of the members are most in jeopardy and where the members need additional protections, the supervisory committees should be reminded of their duties of oversight.

If the supervisory committee is expected to oversee mergers, the supervisory committee must also be protected in the event of a merger. The board of directors should not be able to circumvent the oversight of a supervisory committee by removing the supervisory committee and replacing it with merger-sympathetic members. Therefore, the NCUA may wish to institute rules freezing the removal of supervisory committee members for a certain period after a merger is proposed, except in "for-cause" situations.

Effective oversight by supervisory committees to ensure that transactions, and especially potentially interested transactions, are fair to the members will likely involve an appraisal right or an organized method of valuation by the supervisory committee or some independent committee.[23]

III. Forthright Communications to Members and from Members

While the NCUA's current regulations require certain communications from a credit union's board during fundamental changes and the fiduciary duty requires forthrightness in all board communications to members, we believe that the right for credit union members to voice opposing views is vital to having an adequately informed membership vote.

Credit unions, especially federal credit unions, are founded upon democratic principles. In accordance with these principles, credit union members should be given the opportunity and right to voice opposing views on fundamental corporate change transactions. The NCUA already provides some communication rights for members in the conversion rules. However, we believe that a true right to communication and debate by and among members would protect member interests more fully. Such a right to communication should provide members with access equal to that available to incumbent board members for their campaign materials.

---

[22] We note that the Credit Union movement began in Germany, where corporations, at least publicly traded corporations, are required to have two separate boards, a supervisory board elected by shareholders and labor, and a management board. *See* Thomas J. Andre, Jr., *Some Reflections on German Corporate Governance: A Glimpse at German Supervisory Boards*, 70 TUL. L. REV. 1819 (1996).

[23] We note that in other dual-board structured corporations, such as the German corporations noted above, oversight committees have a right to review and appraise transactions on behalf of the shareholders. Additionally, similar oversight has been suggested for American publicly traded corporations. Some scholars have advocated "change of control boards" which would essentially perform the valuation and appraisal activities to protect shareholder interest. *See* Samuel C. Thompson, Jr., *The Missing Link in Sarbanes-Oxley: Enactment of the "Change of Control Board" Concept, or Extension of the Audit Committee Provisions to Mergers and Acquisitions*, 63 BUS. LAW. 81 (2007).

Re: Comments on Advanced Notice of Proposed Rulemaking for Parts 708a and 708b

An example of a statute in state corporate governance law that allows for member equal access to communications is California Corporations Code Section 7523. The statute reads: "Where a corporation with 500 or more members publishes any material soliciting a vote for any nominee for director in any publication owned or controlled by the corporation, the corporation may provide that it shall make available to all other nominees, in the same issue of the publication, an equal amount of space, with equal prominence, to be used by the nominee for a purpose reasonably related to the election."

Credit unions are already permitted to spend corporate funds on communications from the board to the membership in support of a merger or other transaction. Under the above statute, any legitimate nominee may make communications whenever the corporation solicits votes for a particular nominee. The requirement that the nominee be legitimate adequately protects the credit union's coffers against fraudulent or frivolous requests, as the communication must then be supported by the number of members necessary to nominate said nominee. As applied to federal credit unions and fundamental corporate change, the NCUA could institute a rule providing for publication of a communication submitted to the board with a petition meeting the requirements in the bylaws for nomination of directors. This would thus require a number of members to support a communication for corporate funds to be expended, but would only require a maximum of 500 (under the old bylaws) or 750 members (under the most recent federal credit union bylaws).

Such a communications standard would effectively give members the ability to voice their opinions and engage in debate on matters of fundamental corporate change.

IV. Remedies

As we stated in our introduction, we believe that an important reason for the NCUA to issue regulations in this area is to ensure that credit union members have recourse for wrongs done to them and harms to their residual equity interests. The duties described above and members' interests in credit union equity are somewhat illusory if the members cannot pursue directors for breaches of their duties, whether individually or in a derivative action. Contract claims based on bylaws or even a credit union's articles of incorporation will likely not adequately protect member interests. Enforcement solely by the NCUA of fiduciary duty claims, even in the realm of corporate changes that will be reviewed by the NCUA, will likely not enforce these duties to their fullest extent due to the funding limitations on investigations by the Administration. Therefore, we propose the NCUA examine the various remedies available to equity owners in the states and as related to other types of entities for promising solutions.

A credit union member's interest in credit union equity is residual in nature. Unless a credit union dissolves, the member cannot access this equity. Simultaneously, credit union members have an ownership and voting interest with regard to the credit union. As the NCUA has noted on several occasions, certain types of transactions, most notably those that cause a credit union's

Re: Comments on Advanced Notice of Proposed Rulemaking for Parts 708a and 708b

assets to pass to another charter type, result in credit union members losing some or all of their voting rights.[24] Many of these transactions result in and are motivated by a capital distribution to the members. One effective remedy for credit union members may be to allow them to withdraw an amount equal to their equity interest in the credit union upon dissenting from a fundamental corporate change that results in the loss of the credit union form.

This type of remedy is often called an "appraisal" right. Unfortunately, we have not come across a common law appraisal right that could apply to credit union sales or mergers. Therefore, absent new rulemaking, it does not appear that there would be legal support for an appraisal action by dissenting shareholders of a federal credit union. A credit union appraisal rule might affirm that members are the owners of the institution and have a right to so-called "frozen" capital. However, appraisal rules may create disincentives for normal credit union mergers if drafted too broadly, and perhaps should be limited to apply only where the surviving entity is not a credit union.

Examples of appraisal rights can be found in a federal bank statute, the ABA Model Business Corporation Act, and various states' laws. In the National Bank Act, dissenting shareholders in mergers of national banks or state banks into national banks may request the fair value of their shares in return for the surrender of their stock certificates.[25] Valuation is made by a committee selected in part by both the majority stockholders and the dissenting stockholders.[26] Chapter 13 of the Model Business Corporation Act also provides an appraisal right with slightly different aspects from those of the National Bank laws.

In order to effectuate these remedies, if the NCUA perceives problems with the review of mergers by courts, the NCUA could institute administrative remedies. Rather than providing for a private cause of action in a state or federal court, the NCUA could provide for an administrative review. A recent example of such a provision can be found in the NCUA's recent Final Rule on Member Inspection of Records.

In that rule, now Section 701.3(f) of the NCUA's Rules and Regulations, members may submit disputes to the NCUA Regional Director overseeing their credit union. As stated in the commentary accompanying the Final Rule, "In handling a dispute, the regional director is bound to follow the law with full consideration for the safe and sound operation of the FCU and the protection of members' legal rights."[27] The commentary continues to state that "petitioners have the option of submitting a dispute to their supervisory committee rather than the regional director. If petitioners are dissatisfied with the response of their supervisory committee, they

[24] As noted above, the NCUA has acknowledged in the commentary accompanying its 2006 final rule on conversions that changes away from credit union form result most often in the dilution or altogether loss of voting and residual equity rights for credit union members.
[25] 12 U.S.C. § 215a(b).
[26] 12 U.S.C. § 215a(c).
[27] 72 Fed. Reg. 56247, 56252 (2007).

Re: Comments on Advanced Notice of Proposed Rulemaking for Parts 708a and 708b

will still be able to submit the dispute to the regional director."[28] Such an appraisal remedy would allow members opposed to fundamental corporate change to protect their individual equity interests without much of the lengthy litigations that might otherwise result. This also allows for a full and fair member vote and an undeniable recognition of the equity ownership of members of federal credit unions.

V. Additional Considerations with Hostile Merger Offers

Apart from the issue of fiduciary duties, we feel that we should offer our views on the phenomenon of hostile merger offers, which the NCUA also raises in its ANPR. As mentioned in the preceding sections, the duties of the directors under fiduciary duty standards may be heightened when the directors take defensive measures in response to a merger offer. This heightened duty helps to protect the members against entrenchment and self-interested motives of directors that are implicated by the very nature of many defenses to hostile merger offers.

The reason we discuss this separately is the competing concern for the NCUA of preserving the system of cooperative credit that the Federal Credit Union Act creates.[29] In order to protect this system, the NCUA must in some way protect federal credit unions themselves. Hostile merger offers pose a significant threat to the existence of federal credit unions.

In the corporate world, certain merger offers are considered to be "coercive" due to the nature of the offer—shareholders have an incentive to sell their stock to the acquiring company soon because they get a better price, creating a financial disincentive to holding out and attempting to preserve their corporate identity. While the NCUA has already taken the first step in stopping coercive offers for federal credit unions by declaring per-capita dividends and similar merger-related distributions illegal, potential acquirers of credit unions have only just begun devising potential merger offer systems. These potential acquirers, if they are not credit unions, may have the ability to leverage their equity and raise funds quickly to make large scale acquisitions. While the NCUA has always reserved the ability to reject merger plans, this regulatory scheme

---

[28] *Id.*

[29] *See* Credit Union Membership Access Act, Aug. 7, 1998, P.L. 105-219, § 2, 112 Stat. 913–14 ("An Act . . . to preserve the integrity and purpose of Federal credit unions . . . ."); 12 U.S.C. § 1751 Note ("(1) The American credit union movement began as a cooperative effort to serve the productive and provident credit needs of individuals of modest means. (2) Credit unions continue to fulfill this public purpose, and current members and membership groups should not face divestiture from the financial services institution of their choice as a result of recent court action. (3) To promote thrift and credit extension, a meaningful affinity and bond among members, manifested by a commonality of routine interaction, shared and related work experiences, interests, or activities, or the maintenance of an otherwise well-understood sense of cohesion or identity is essential to the fulfillment of the public mission of credit unions. (4) Credit unions, unlike many other participants in the financial services market, are exempt from Federal and most State taxes because they are member-owned, democratically operated, not-for-profit organizations generally managed by volunteer boards of directors and because they have the specified mission of meeting the credit and savings needs of consumers, especially persons of modest means. (5) Improved credit union safety and soundness provisions will enhance the public benefit that citizens receive from these cooperative financial services institutions.")

Re: Comments on Advanced Notice of Proposed Rulemaking for Parts 708a and 708b

does not protect federal credit unions from the significant cost of battling a hostile offer once made.

In the face of this competing interest, and to provide balance with the fiduciary duties of directors, the NCUA should act to protect members from hostile offers and their potential to destroy the federal system of cooperative credit. We believe that this can be accomplished by keeping merger decisions in the hands of the board and the members of a federal credit union, not in the hands of a potential acquirer. The board of directors of a federal credit union fulfills a gatekeeper function, filtering out coercive and insufficient offers. If the membership feels that a board's decisions are breaches of their duties, the membership has recourse through their supervisory committees. We believe that in addition to their supervisory committees, the membership should be able to turn to their Regional Director for resolution of disputes regarding breaches of director fiduciary duties, much in the manner described above in the context of appraisals.

The issue remains that an outside entity may communicate coercive hostile offers to the membership in a manner hostile to the sitting board of a federal credit union. This practice should not be permissible considering the interest in protecting the credit union system and the adequate protections for member interests found in the fiduciary duty and recourse with the supervisory committee or through the NCUA's Regional Directors.

An example of a rule that goes far in accomplishing this is the regulation adopted by the Texas Credit Union Department.[30] This rule prohibits one credit union from offering to the members of another credit union "a promise . . . to pay . . . a sum of money or material benefit upon the successful completion of a merger of the two credit unions."[31] The NCUA should adopt a similar rule, but should extend the protection to include offers or promises by non-credit unions as well. While the credit union industry has only seen one such offer made, and it was made by a federal credit union, there are no additional safeguards provided to protect federal credit unions from the expense of defending against hostile offers by banks, thrifts, and other types of financial institutions.

In the absence of such a rule, the NCUA may wish to examine the federal credit union bylaws and possible amendments to allow boards to adopt additional protections against hostile offers while still maintaining the aspects of member choice and member franchise that are vital to the credit union movement.

---

[30] 7 Tex. Admin. Code § 91.1003.
[31] *Id.* § 91.1003(a)(3) (defining "merger inducement"); § 91.1003(b) ("A credit union may not offer a merger inducement to another credit union's members as a means of promoting a merger of the two credit unions.").

Re: Comments on Advanced Notice of Proposed Rulemaking for Parts 708a and 708b

VI. Conclusion

To conclude, we reiterate our basic points and concerns. We believe the most important aspects of the ANPR and any rulemaking in this field to be the fiduciary duty of directors and the obligations that accompany it. Additionally, we believe that the general duties are already legal requirements for credit union directors. However, due to uncertainty in some courts and most boardrooms, these duties may not be complied with, and therefore NCUA should provide guidance in the form of new rulemaking. These new rules should codify the fiduciary duty and the business judgment rule, including those nuances to the business judgment rule that bring heightened scrutiny upon directors in types of transactions which carry greater risk of self-dealing or conflicts of interest.

In addition to codification of current standards, the NCUA should consider instituting rules tailored to the credit union structure that provide protection for members, especially in relation to the existence of and functions performed by credit union supervisory committees. Also, the NCUA should ensure that members have adequate remedies, whether in courts or at the administrative level, allowing members to exercise their rights as owners with some variety of private action. This will free the NCUA from the administrative burden of an inspection function by leaving inspection to a system of discovery.

Also, in the area of hostile merger offers made to members of federal credit unions, we believe the NCUA should enact rules limiting or eliminating the ability of a third party to interfere with the relationship between the membership of a federal credit union and its board. An effective way of doing so would be to prohibit merger inducements offered directly to the membership of a federal credit union by another entity.

We believe that the NCUA has the authority to regulate in all of these areas to the extent to which we have suggested. Regarding mergers, the NCUA has plenary authority to regulate all federal credit union mergers with noninsured institutions and plenary authority to regulate all mergers with insured institutions.[32] The Federal Credit Union Act gives NCUA discretion regarding federal credit union mergers[33] and conversion away from federal insurance, and a rule interpreting these sections would likely withstand judicial review unless arbitrary and capricious or manifestly contrary to the statute.[34] While charter conversion from a federal credit union charter to a mutual savings bank charter can only be regulated by the NCUA to the extent that other financial regulators regulate similar changes, we believe that codification of fiduciary duties would be no more or less restrictive than other federal schemes.[35]

---

[32] 12 U.S.C. §§ 1766(a), 1785(b), 1785(c), 1789(a).
[33] 12 U.S.C. § 1766(a).
[34] *See* Chevron v. NRDC, 467 U.S. 837, 842-44 (1984) (holding that agency interpretations receive the highest level of deference when Congress has explicitly left "a gap to fill").
[35] We again note the NCUA's commentary accompanying its final rule on conversions: "NCUA's rule should not, when taken in its entirety, constrain a converting credit union's action or choice more significantly than the rules of

Re: Comments on Advanced Notice of Proposed Rulemaking for Parts 708a and 708b

We hope that the NCUA will find these comments and suggestions helpful in determining its course of action in this area. We thank you for the opportunity to comment on these important topics.

Respectfully,

STYSKAL WIESE & MELCHIONE, L.L.P.

Joseph S. Melchione

Timothy I. Oppelt

JSM/TIO/so

other financial regulators taken in their entirety." 71 Fed. Reg. 77150, 77151 (2006). In their entirety, the rules governing conversions of other financial institutions will similarly involve fiduciary duties of directors. Codification of fiduciary duties for directors of federal credit unions will not restrict conversions any more than they are already restricted.